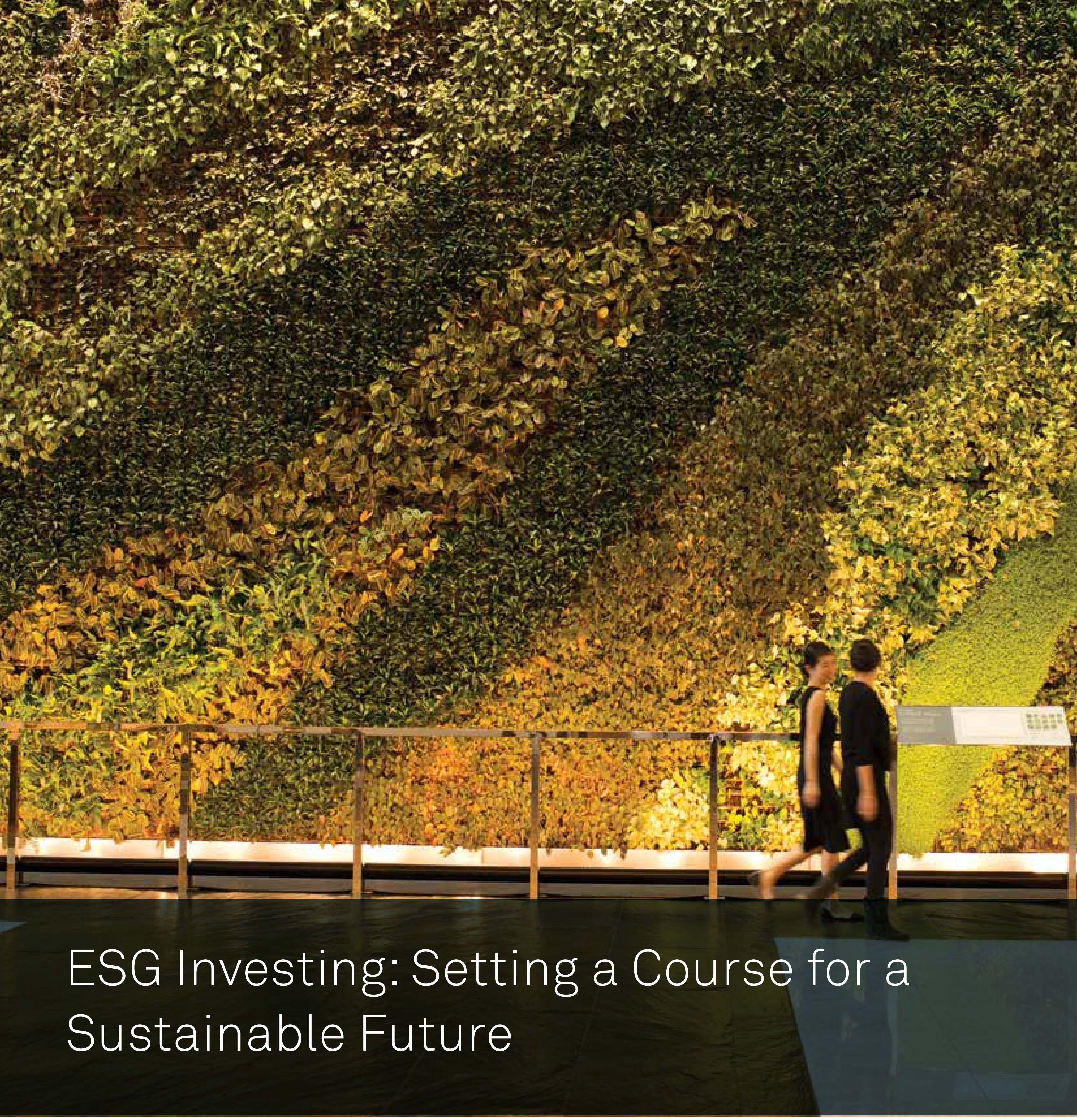


ESG Investing: Setting a Course for a Sustainable Future

BNY MELLON

Author:
Mareike Dreisbach—Regional Product Manager,
EMEA Strategy and Product Management,
BNY Mellon

Contributors:
Marvin Vervaart—Asset Owner Segment Head,
EMEA, BNY Mellon

Fraser Priestley—Head of Performance and Risk,
EMEA, BNY Mellon

EXECUTIVE SUMMARY:

Bill Gates famously observed that we tend to overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten. There is a strong likelihood that in ten years we will look back and realise we have all become sustainable investors. It may take longer, but we are in little doubt that asset owners, asset managers and their service providers are witnessing the early stages of a secular shift. The long-term trend in investment is long-term investing. And the pressure to both precipitate and assess investment success not just by considering financial criteria, but also environmental, social and governance (ESG) factors, will grow further. As this report shows, the critical elements of the new landscape are not yet in place. But we believe now is the time for all investors to start planning their sustainable future.

- Sustainable investing is gaining significant momentum as a critical consideration for all investors and their service providers due to a combination of demographic and political forces with a growing appreciation of risk/return benefits among asset owners and managers.

- In parallel with the growing popularity of sustainable investment, industry bodies are coordinating to create a global framework to help investors measure non-financial performance of their investment decisions and incorporate ESG principles into their investment strategies.

- Meanwhile governments are responding to the UN Sustainable Development Goals (SDGs) by developing legislative proposals for sustainable finance, notably the measures set out in the European Commission's March 2018 Action Plan entitled "Financing Sustainable Growth"; these measures include establishing an EU classification system for sustainable activities, creating standards and labels for green financial products, and requiring that sustainability preferences be taken into account when financial advice is provided.

- There are still many challenges—around balancing investment priorities and measuring impacts—but a growing selection of tools and data sources are helping both asset managers and asset owners to target and deliver a more sophisticated and diverse range of outcomes.

- For value alignment strategies, investors are using compliance monitoring services such as screening tools to exclude stocks that do not align with their values and priorities.

- When taking a proactive ESG integration approach, investors require a range of engagement-related services, including proxy-voting and class action solutions, as well as support on dialogue and divestment.

- As ESG investing becomes more precise, with investors targeting specific impacts through their strategies, new tools and solutions are required to identify and measure the performance of suitable investment opportunities.

Sustainable Investment Goes Mainstream

In former times, many investors have perceived a tension between the short-term pure profit motive and a longer-term, sustainable approach. Until recently, sustainable investment has often been seen as a niche area, perhaps due to its association with specialists groups, with particular ethical or religious principles. Over the past decade however, increasing concern over the financial, social and environmental risks of short-term attitudes has brought sustainable investment into the mainstream. This was complemented by the increasing awareness that ignorance of ESG factors creates risks that may adversely impact investment performance.

Asset owners and their service providers are embracing sustainable or responsible investment principles[1]—some holistically, others more cautiously. ESG has breached the wall that previously isolated socially responsible investing, with a wider number of mainstream investors looking to utilise one or more of its three pillars: values-based avoidance screening; proactive sustainability-focused analytics; and corporate engagement and impact investing. Recent research[2] suggests 84% of asset owners are pursuing or actively considering ESG integration, with almost as many seeking to align with the United Nations' 17 Sustainable Development Goals (SDGs).

This is no small undertaking, and there is no quick fix, with adjustments required throughout the investment process. Regardless of precise strategy, incorporation of ESG principles and targets requires the skills and resources to establish and monitor new investment policies, guidelines, operations and selection criteria. Unsurprisingly perhaps, almost seven in ten asset owners identify inadequate information as the biggest challenge when adopting ESG principles. According to CFA Institute research, 55% of investment managers report that a "lack of appropriate quantitative" ESG data limits use of non-financial information in the investment process[3].

Even so, momentum is accelerating, driven by a number of push and pull factors. First, there is a growing appreciation that sustainable investment offers risk and return advantages, as well as the wider social, environmental and governance benefits.

Second, many of today's end-investors are driven as much by making a difference as making a profit. According to CFA Institute research[4], 78% of millennials take at least one ESG issue into account when investing. BNY Mellon's own research into 'Generation Lost' found that millennials would allocate 42% of their portfolio on average to social finance products[5]. Asset owners, asset managers and their service providers are responding to evolving end-investor priorities by investing in skills and expertise, reviewing investment strategies and developing product ranges.

Third, public sector commitments require private sector responses. The most galvanising example is the UN SDGs and the environmental targets of the Paris Agreement on climate change, both signed in 2015. The SDGs provide a global framework for achieving development goals, but also an explicit focal point for the realignment of private sector strategies.

More than US$22.8 trillion was invested sustainably in 2016[6], over half of which was in Europe, with ESG assets rising globally 12% year on year. This reflects assets attracted by new instruments designed to achieve specific ESG objectives, as well as adjustment of existing portfolios to reflect ESG considerations.

Nevertheless, recent estimates[7] suggest US$2.4 trillion in public and private investment per annum is needed to achieve the SDGs by 2030, generating US$12 trillion of business opportunities along the way[8]. With global AUM totalling US$84.9 trillion[9] this is achievable. But motivation and opportunity are not enough: the means, in relation to adequacy of data and standardisation, is where we currently fall short.

More than **US$22.8 trillion** was invested sustainably in **2016** over half of which was in Europe, with ESG assets rising globally **12%** year on year[6].

[1] Responsible investment is an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns. (https://www.unpri.org/pri/what-is-responsible-investment)

[2] Sustainable Signals: Survey conducted by the Morgan Stanley Institute for Sustainable Investing of 118 public and corporate pensions, endowments, foundations, SWFs, insurance firms and other large asset owners worldwide (just over half from Europe) (Morgan Stanley, 2018)

[3] Global Perceptions of Environmental, Social, and Governance Issues in Investing (CFA Institute, May 2017)

[4] Global Perceptions of Environmental, Social, and Governance Issues in Investing (CFA Institute, May 2017)

[5] Generation Lost – Engaging Millennials with retirement saving (BNY Mellon, 2015)

[6] 2016 Global Sustainable Investment Review (Global Sustainable Investment Alliance, 2017)

[7] Transforming our world: the 2030 Agenda for Sustainable Development (2015), Sustainable Development Knowledge Platform (https://sustainabledevelopment. un.org/post2015/transformingourworld)

[8] Better Business, Better World (The Business and Sustainable Development Commission, 2017)

[9] https://www.pwc.com/gx/en/industries/financial-services/asset-management/publications/asset-wealth-management-revolution.html

An Emerging Framework

Measurability and comparability of non-financial performance are perhaps the biggest hurdles to ESG investment growth. Standards exist and taxonomies are being developed, as are legislative proposals. The UN SDGs and Paris Agreement have raised awareness and activity levels, but much is left to do.

For asset owners and managers

Efforts at creating a consistent global framework for integrating and measuring ESG impacts within the investment process began in 2006, when a UN-convened working group defined six Principles for Responsible Investment (PRI). Now adopted by investors representing US$70 trillion, the principles have been augmented by reports, case studies and other advice for asset managers and asset owners, drilling down by asset class, geography and investment function.

Earlier this year, the PRI Association published concrete guidelines[10] to help asset owners devise investment strategies that fully consider sustainability factors. It has also issued reports highlighting how asset managers and owners should incorporate sustainability into equity and fixed-income investing, as well as a guide to ESG manager selection[11] which recommends "well-executed dialogue" alongside product- and firm-level data. The PRI has also launched an Impact Investing Market Map to help investors identify suitable impact investing companies and thematic investments, offering common definitions, criteria and KPIs.

In partnership with the CFA Institute, the PRI Association recently published best-practice guidance on ESG integration based on case studies across equity and fixed income, as well as the first of three regional reports, highlighting investor attitudes, challenges and practices in the Americas.

For corporates and their investors

Corporate sustainability reporting may not yet be consistent, or fully mapped to UN SDGs, but it is increasing. According to KPMG[12], 93% of the largest 250 firms globally now report on their sustainability performance. For smaller companies there is still some way to go in terms of having the resources and ability to deliver insights and information on the ESG credentials of their business.

The Global Reporting Initiative (GRI) has been refining its Sustainability Reporting Standards framework since 1997 and is developing a Sustainability Data Platform, leveraging existing reports. Formed by the Financial Stability Board, the Task Force on Climate-related Financial Disclosures issued voluntary recommendations in June 2017 on how to incorporate climate-related risks and opportunities into financial reports. More than 275 firms worth a combined US$6.6 trillion signed up, including financial institutions responsible for US$86 trillion in assets. Further, more than 100 large firms[13] have committed to science-based targets to track their progress toward a low-carbon economy.

PRI and GRI work closely with the UN Global Compact (UNGC) to help corporates and stakeholders operate along sustainable lines and support SDGs.

The UNGC outlined the role of private sector investment in sustainable development[14], and the three bodies have since collaborated to define SDG reporting practices and requirements. Recent publications provide a methodology for measuring and reporting the impact of firms' SDG support, advice on aligning business strategy with SDGs and metrics to meet investors' SDG disclosure needs.

EU proposals

The UN SDGs have also contributed to the development of common definitions and guidelines for sustainable investment through the flow of legislation spurred by government commitments.

Following two well-received and influential reports from a High-Level Expert Group on Sustainable Finance, the European Commission published on 8 March 2018 an Action Plan entitled "Financing Sustainable Growth". The Action Plan sets out 27 initiatives or areas of work that aim to: (i) reorient capital flows towards sustainable investment, (ii) manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues, and (iii) foster transparency and long-termism in financial and economic activity[15].

On 24 May 2018, the European Commission issued a first set of legislative proposals relating to initiatives set out in the Action Plan. The proposals aim to:

1. Provide clarity on what sustainable investments are by creating an EU-wide classification system or taxonomy to provide businesses and investors with a common language to identify what degree economic activities can be considered environmentally-sustainable;

2. Ensure that asset managers, institutional investors, insurance distributors and investment advisors include ESG factors in their investment decisions and advisory processes as part of their duty to act in the best interest of investors or beneficiaries;

3. Create a new benchmark category for low-carbon and positive-carbon impact benchmarks; and

4. Ensure that investment firms and insurance distributors integrate sustainability preferences into their suitability tests when offering advice to investors and that the products offered meet their clients' needs.

[10] How to Craft an Investment Strategy (PRI, 2018) (https://www.unpri.org/asset-owners/investment-strategy)

[11] Asset owner manager selection guide: Enhancing relationships and investment outcomes with ESG Insight – PRI (March 2018). (https://www.unpri.org/asset-owners/asset-owner-guide-enhancing-manager-selection-with-esg-in

[12] KPMG Survey of Corporate Responsibility Reporting (2017)

[13] From commitment to Action' blog on sciencebasedtargets.org (April 2018)

[14] Private Sector Investment and Sustainable Development (UNGC 2015) (https://www.unglobalcompact.org/library/1181)

[15] The Reports from the High-Level Expert Group, the Action Plan, and the legislative proposals relating to the Action Plan are available on the website of the European Commission at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance_en

Future Challenges for Asset Owners and Asset Managers

This fast-evolving landscape offers considerable support to asset owners and managers as they integrate ESG into their investment strategies and product offerings. But many challenges lie ahead as individual institutions navigate their path through a complex and incomplete eco-system.

Combining social benefits and financial returns

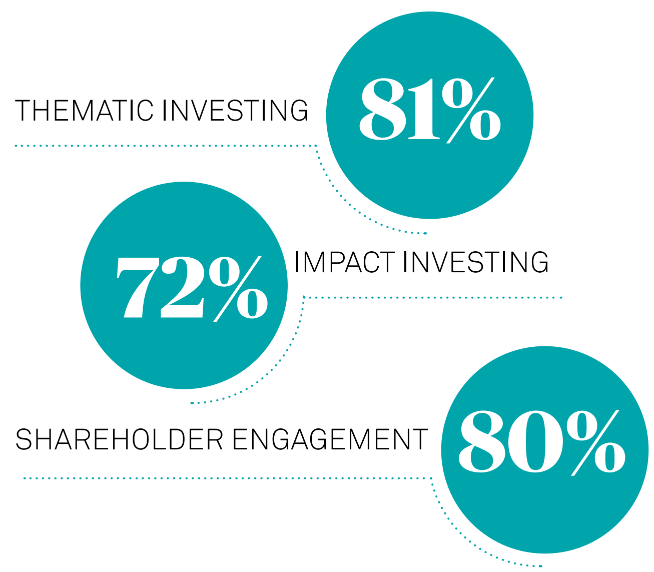
Historically, asset owners' interest in sustainable investment has been tempered by questions about whether there is a 'trade-off' between returns and wider benefits. There is now statistical evidence that suggests incorporating ESG factors in investment decisions can improve returns in the long term, partly by avoiding the higher risks borne by firms without an ESG focus.

In 2016, Deutsche Asset Management and the University of Hamburg[16] aggregated more than 2,000 empirical studies to demonstrate that ESG principles need not compromise profits. The analysis found a non-negative relationship between ESG and corporate financial performance in 90% of studies, with the vast majority reporting positive correlations. Meanwhile, a Morningstar study[17] found a statistically significant relationship between mutual funds with higher sustainability ratings and lower volatility.

While from a public policy perspective the benefits of incorporating ESG factors and risks into investment decisions are clear, there is still an ongoing debate as to the degree to which ESG integration can improve returns for all asset managers.

One relevant factor in the debate is that information as to the ESG factors of an asset is still today incomplete, and is potentially inconsistent with the ESG information for other assets. What this means is that a sole focus on ESG factors may lead to biases in pricing and in investment allocation.

Popularity of sustainable investing among asset owners[20].



Measuring impact

There is not yet a set of international standards to validate the ESG credentials of an investment. As such, asset owners are leveraging industry-level work on definitions, principles and frameworks alongside emerging data sources, from specialists with proprietary evaluation methodologies to new tools from well-established data providers, including ratings agencies.

And although the UN SDGs add undeniable impetus, asset owners' efforts to understand their investments' performance against non-financial targets are blurred by the sheer number of SDG targets (169), not all of which are easily measurable. Often, "significant additional work is needed to address the lack of business disclosures or sector-specific guidance"[18]. Whilst GRI and UNGC establish a "unified mechanism"[19] for comparable and effective SDG reporting, most companies use pre-existing reporting standards.

In this fluid context, specialist data providers and ratings agencies are evolving their models to address anomalies such as bias toward well-resourced firms due to superior reporting capabilities rather than positive ESG outcomes.

Matching tactics to (increasingly sophisticated) strategies

The nature of an asset owner's ESG investment priorities will influence its tactics, including choice of managers, funds, and asset classes. Even alignment of broad-based ESG objectives with the components of a particular fund might require regular reappraisal, but the targeting of more niche impacts will require very precise investment tools.

Managers are launching funds that target specific objectives or broader ESG outcomes, or marketing themselves as factoring in ESG across all their products. In terms of returns and impact, both the funds and means by which they are ranked are in their infancy.

As such, those in the early stages of their ESG journey might consider sustainability reporting from public companies only sufficiently detailed and comparable for ESG only to partially inform an equity-based strategy. Targeting specific outcomes requires more standardisation work on labelling.

Choice of investment strategy is widening in both the retail and institutional markets, but increasing supply does not guarantee the availability of an appropriate strategy for a particular investor, as increasingly sophisticated objectives target specific social or environmental results. The apparent popularity of thematic investing (81%), impact investing (72%) and shareholder engagement (80%)[20] among asset owners suggests that sustainable investing will take a highly pro-active approach, requiring access to a wide range of resources, skills and tools.

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[16] https://www.db.com/newsroom_news/2016/ghp/esg-and-financial-performance-aggregated-evidence-from-more-than-200-empirical-studies-en-11363.htm

[17] Higher Sustainability Ratings Can Mean Lower Risk. Morningstar, as of October 13, 2016

[18] GRI / UNGC's Business Reporting on the SDGs – An Analysis of the Goals and Targets (2018)

[19] Tim Mohin, CEO, GRI in GRI / UNGC's Business Reporting on the SDGs—An Analysis of the Goals and Targets (2018)

[20] Asset owner survey conducted for Morgan Stanley Institute for Sustainable Investing survey (2018)

Aligning Principles to Drive Success

As they execute on their newly formulated ESG investment strategies, investors are typically looking for support with regard to the main three prevailing approaches to ensure results align closely with priorities:

- **Value Alignment**—Asset owners and asset managers looking to exclude stocks that do not align with their values and priorities will use compliance monitoring support in the form of screening tools;
- **ESG integration**—Institutions wishing to take a proactive approach to ESG-informed risk mitigation and alpha generation will make use of an established range of engagement-related services, including proxy-voting and class action solutions, as well as support on dialogue and divestment;
- **Thematic impact**—As ESG investing becomes more precise, with investors targeting specific impacts through their strategies, new tools and solutions will be required to identify and measure the performance of suitable investment opportunities. This includes use of alternative data sets in the analysis, performance reporting, benchmarking and monitoring of ESG products, including their ability to meet specific impact measures, such as contribution to UN SDGs.

BNY Mellon will continue to evolve its services, introducing new solutions as clients' ESG-related strategies and requirements develop. For example, digital tools being prototyped at BNY Mellon's London Innovation Center can help underlying policy holders and clients understand the ESG profile of their investments.

Time for Action

Some estimates predict ESG assets will comprise two-thirds of assets managed by global funds by 2020[21], although largely still using 'do no harm' exclusionary screening. Investors and asset managers have the opportunity to purposely invest in companies that do not demonstrate good behaviour, using the position as a shareholder to increasingly engage in proactive dialogue and influence corporate behaviour in order to meet ESG targets that are both relevant for the company's business model and aligned with investor ESG priorities. The political and market forces behind sustainable investment are strengthening. Sustainability-focused millennials will make up one-third of the workforce by 2020 as well as being poised to inherit approximately US$30 trillion of wealth[22]. Meanwhile, political pressure continues to mount, with UN under-secretary-general for economic and social affairs Liu Zhenmin recently warning[23] that finance sector short-termism could undermine the UN's SDGs.

But the evidence demonstrates investors increasingly see a need for a secular change: ESG is becoming a pervasive consideration across asset owners' investment strategies and asset managers' product ranges. Asset owners will have to choose their own approach to ESG, deciding what metrics and outcomes are important to them, informed by end-investor priorities. Investment managers will mainly focus on how to construct, market and distribute ESG funds and implement ESG solutions required by institutional clients. Service and infrastructure providers will also have to adjust, providing the support needed for cost-effective decision making. The frameworks and guidelines currently being put in place will help investors to interpret and evaluate the increasing data flows, leading to a greater consensus on best practice. As your strategy evolves, so will our suite of solutions. Like many of you, we're in sustainable investment for the long term.

[21] Pictet Asset Management research cited in https://qz.com/1309419/when-will-socially-responsible-investing-become-just-investing/

[22] EY: Sustainable investing: the millennial investor (2017)

[23] Time for a Global Financial Makeover - https://www.project-syndicate.org/commentary/global-finance-and-sustainable-development-by-liu-zhenmin-2018-04

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